

# **Updated Release: 2010 Iowa Tax Expenditure Study**

June 2013

*NOTE: This update to the March 2013 release includes the following additional information:*

*New file covering 34 Tax Expenditures for Tax Credits (see page 8 for more information);*

*One additional sales and use tax expenditure – Tangible Personal Property for Resale; Estimates for two sales and use tax expenditures previously listed as Not Estimated – 1. Lawn Care Services Audit Limitation; 2. Medicaid Service Providers;*

*Updated estimate for one sales and use tax expenditure – Industrial Machinery, Equipment and Computers; and*

*Estimate for one property tax expenditure previously listed as Not Estimated -- Web Search Portal and Business Property.*

## **Purpose of the Tax Expenditure Study**

Government programs funded through direct appropriations are subject to periodic review as part of the state budget process. But programs funded through special features of the tax code, such as tax exemptions, tax credits, tax deductions, and income tax exclusions, generally escape such examination. Therefore, this study is intended to provide more information about these features of the Iowa tax statutes and to improve government accountability.

The estimates presented in this study are for taxable events occurring in calendar year 2010 and are based upon the most recent data available adjusted to reflect the levels of activity in 2010, if necessary. It is noted when estimates have been calculated for other periods. The estimates are based only upon the impact on receipts of the State of Iowa and only upon receipts going into the General Fund. Impacts on local option income surtaxes or local option sales taxes are not estimated. For this preliminary release of the study, tax expenditures are limited to those related to sales and use taxes, property taxes, and tax credits.

## **Definition of Tax Expenditure**

A tax expenditure is any exemption, credit, deduction, or exclusion from the tax base that is tied to a specific provision in tax law. A tax expenditure is generally understood to be a preferential provision in the tax law that produces a reduction in tax from that which would be imposed without the provision. In addition, tax expenditures are generally targeted to a limited group of taxpayers. The basis of this study is to identify provisions in Iowa law and estimate the impact to the General Fund of each of the provisions that satisfy the definition of a tax expenditure.

Tax expenditures are in general not appropriations, but can be viewed as an alternative to direct government appropriations. However, some property tax expenditures are directly funded by State of Iowa appropriations. The funding may be distributed to local governments or to individuals. Although tax expenditures allocate resources for specific public purposes like appropriations, they achieve policy goals indirectly by changing the cost of a particular action.

There are two approaches to identifying tax expenditures. The first approach is more traditional and uses a widely accepted, relatively narrowly focused set of criteria. Tax expenditures are identified by first defining the basic structure of the tax under consideration and any provisions which deviate from the basic tax structure are then considered to be tax expenditures. Provisions which form part of, or define, the basic tax structure are not tax expenditures. Under this approach, some deductions, exemptions and exclusions are not considered tax expenditures because they are a part of the basic tax structure. For example, because income taxes are imposed on net income, ordinary and necessary expenses are properly deductible in determining income and are, therefore, not tax expenditures.

Under a more broadly defined theory, tax expenditures are defined as all exemptions, exclusions, deductions, and credits. While this approach avoids some of the definitional issues encountered under traditional tax expenditure analysis, it includes many items as tax expenditures which are generally accepted as a part of the tax base.

In this study, the traditional tax expenditure analysis is used. Within the traditional approach, selection of particular tax expenditures is still a subjective process. For example, tax changes that alter the timing of when revenues or expenses are realized for tax purposes are not treated as tax expenditures. Although an attempt was made to be as inclusive as possible within the general criteria, there remains potential for additional tax expenditures to be identified in the future.

### **How the Tax Expenditures Have Been Estimated**

Two primary assumptions have been used for the Iowa tax expenditure study that are generally consistent with the assumptions used for calculating tax expenditures in other states and by the federal government. The first of these assumptions is that economic behavior is not altered. By definition, tax expenditures are sometimes created in order to bring about an expected result or to encourage a particular behavior. Estimates in this study are done assuming that elimination of the tax expenditure will not otherwise change behavior. This assumption avoids the necessity for making subjective assumptions about behavior and the possibility of inconsistency in methods and outcomes. Such analysis is beyond the scope of this study.

The second assumption used in this study is that tax expenditures are independent of other tax provisions. The fiscal impact of one tax provision can affect the fiscal impact of another tax provision. For example, under the individual income tax, eliminating a nonrefundable credit such as the personal credit could result in taxpayers being able to utilize more of other nonrefundable credits, but the estimate of the tax expenditure value

for each credit assumes all other credits remain in place. This type of impact is beyond the scope of this study.

Another important issue to note is that tax expenditure estimates are not the same as budgetary fiscal estimates. Although the provided estimates of tax expenditures indicate the magnitude of the revenue gain from repeal of specific provisions, actual budgetary fiscal impacts of legislative changes may produce different results. The primary reason for this variance is the use of different basic economic assumptions or time periods when compiling the estimates. Another reason for possible differences is the assumption of independence when calculating tax expenditures contrasted with budgetary fiscal estimates that are often considered in the context of other changes.

When possible, the primary sources of information used to estimate the tax expenditures were tax returns and filing information. When that was not possible, secondary sources were used.

The estimates in this study relate to expenditures estimated for the 2010 calendar year for sales and use taxes and tax year 2010 for tax credits. For property tax, the estimates relate to property valuations for the year 2008 (that would correspond to tax bills due in 2010) or for appropriations occurring during 2010.

## Tax Expenditure Data Fields

The fields in the various Tax Expenditure files are the following:

**Title:** Expenditure name

**Tax Type:** Tax base affected by the expenditure

**Expenditure Category:** Broad group of expenditure purpose

**Expenditure Type:** Exemption; Partial Exemption; Credit; Deduction; Federal Base (expenditure is a result of the State of Iowa coupling with the Internal Revenue Code)

**Iowa Code Citation:** Chapter and section containing the expenditure

**Iowa Administrative Code Citation:** Chapter and section containing the rules used to administer the expenditure

**Description:** Details about the expenditure

**Final Result:** Result of efforts to estimate the value of the expenditure including Estimated; Estimated – Minimal (estimate was less than \$100,000); Not Estimated (data not available to make a reasonable estimate); See Description (expenditure included in another expenditure estimate indicated in the Description field)

**Assessment Change Value:** Property Tax Only – Estimated change in the assessment of property values subject to various property tax levy rates as a result of the exemption; rounded to the nearest one hundred thousand

**Tax Expenditure Value:** Estimated reduction in taxes collected as a result of the exemption, credit, or deduction; rounded to the nearest one hundred thousand

**Estimate Year:** The year the expenditure is estimated to reduce revenues

## Tax Base Descriptions and History

Before considering any exceptions to the tax base, a general description of the current tax base and rates and a short history are provided. The following descriptions cover the taxes considered in this study.

### Sales and Use Taxes

Both the Iowa sales tax and the use tax were enacted in 1934. Sales tax is imposed on the gross receipts from the sale of tangible personal property sold at retail and of enumerated services. The use tax is meant to complement the Iowa sales tax. The general rule is that a transaction is subject to Iowa use tax when it is completed outside the State but involves tangible personal property sold for use in Iowa. The principle also applies to the sale of taxable services purchased outside of Iowa for use in Iowa. Any transaction where sales tax has been paid, at a rate equal to or higher than the Iowa sales tax rate, is exempt from use tax.

The sales and use tax rate in 2010 equaled six percent and was applied to most purchases of goods and a select group of services. One percentage point of the Iowa sales and use tax is appropriated to school infrastructure and property tax relief. Additionally, a local option sales tax may apply with a maximum rate of one percent for a maximum State and local sales tax rate of seven percent. The local option sales tax is a local government tax and is not taken into consideration in the estimates presented. The history of the Iowa sales and use tax rate is presented in the table below.

**History of Iowa Sales and Use Tax Rates**

Date of Change	Tax Rate
April 1, 1934	2.00%
July 1, 1955	2.50%
July 1, 1957	2.00%
October 1, 1967	3.00%
March 1, 1983	4.00%
July 1, 1992	5.00%
July 1, 2008	6.00%

Iowa taxes more services than many states, but most business services, such as accounting, engineering, and legal services, remain exempt from Iowa sales and use taxes. Because these services have never been subject to Iowa tax they are not considered in this study.

During calendar year 2010, sales tax, retailers use tax, and consumers use tax liabilities totaled \$2,294.1 million.

## **Property Tax**

In Iowa, the property tax is used only by local government entities that are permitted by state statute to impose the tax. The property tax is levied on the taxable value of real property. The consolidated tax rate differs in each locality and is a composite of county, city, school district, and special levies.

### *Tax Base and Rates*

The tax levy rates are expressed in dollars and cents per \$1,000 of assessed valuation. The property tax due and payable in a fiscal year is determined by multiplying the consolidated levy rate by the assessed value of the property. The assessed value of the property is that determined as of January 1 of the year preceding the year in which the fiscal year begins, i.e., 18 months prior, adjusted by the applicable rollback. The consolidated levy rate is the total levy rates of all jurisdictions in which the property is located.

### *Assessment*

Real property is placed in one of four classes: agricultural, residential, commercial, or industrial. Commercial property includes buildings containing three or more separate residences, except condominiums, multiple housing cooperatives, and certain non-profit housing.

Most real property is assessed locally by either the county or city assessor. The assessment year starts on January 1 of each calendar year. Every two years in the odd-numbered year, local assessors are required to revalue all real property in their jurisdictions. Also every two years in the odd-numbered years, the Department of Revenue issues equalization orders. In this process, the Department of Revenue reviews the level of assessment of property within each class of property, excluding industrial. If the aggregate assessed valuation of that class of property is at least five percent above or below the actual valuation of that class of property as determined by the Director as set out in the abstract of assessment, the Department of Revenue orders the equalization of the levels of assessment of that class of property.

Tax base assessment for taxable real property is one hundred percent of market value. The foundation for agricultural property is a productivity value rather than market value.

### *Central Assessment*

All lands, buildings, machinery, and equipment belonging to electric companies (including rural cooperatives), gas companies (including pipelines), railway companies, telephone/telegraph companies, and express delivery companies are assessed by the Department of Revenue and subject to property taxation by local governments.

For assessment years beginning January 1, 1999 and after, central assessment of entities involved in the production, delivery, and transmission of electricity and natural gas was replaced with an excise tax on their production, delivery, and transmission. The excise tax rates vary annually by service area. An annual statewide property tax is also imposed, at a rate of three cents per \$1,000 of assessed value, on all property subject to the excise tax.

### *Equalization*

In order to prevent wide variations between assessments statewide of real property in any one class, the equalization process takes place in each odd-numbered year. As the first step of the process, which is carried out in its entirety by the Department of Revenue, the Department conducts a statewide review of the level of assessment of property within each class for every jurisdiction. If the aggregate assessed valuation of a class of property within a jurisdiction is at least five percent above or below the market value of that class of property as established through statistical analysis and abstract of assessment submissions, equalization of that class of property is required. Equalization is accomplished by increasing or decreasing the aggregate valuations of certain classes of property within jurisdictions by a percentage necessary to adjust the level of assessment to actual value. Equalization orders are restricted to equalizing the aggregate valuations of entire classes of property and may not adjust the valuations of individual properties. Equalization is not considered a tax expenditure but rather an establishment of a tax base.

### *Rollback*

The taxable value of property may be a percentage of the assessed value as a result of statewide limitations on annual growth in assessed value. The statewide limitation on growth is four percent annually (eight percent annually for utilities). Increases in the assessment of residential and agricultural property are tied to each other. The annual increase in each class of property is limited to the smaller of the two increases in either class of property. In November of each year, the Director of Revenue certifies the limitation percentages to county auditors. The rollback percentage is multiplied by the assessed value to obtain the taxable value of the property less any exemptions or partial exemptions. Property tax rollback provisions are considered a tax expenditure, but were only applied to agricultural and residential properties in the 2008 assessment year.

## **Tax Credits**

A tax credit is an amount deducted from a taxpayer's liability to decrease the amount of tax owed to the State. Iowa has two types of tax credits, nonrefundable and refundable. If a nonrefundable tax credit exceeds a taxpayer's tax liability, the amount of tax allowed is limited to tax liability and the balance of the credit either expires or can be carried forward to the next tax year. Refundable tax credits can be claimed for the full amount regardless of tax liability, any amount that exceeds tax liability will be paid to the taxpayer as a refund. Tax credits may be applied towards individual income, corporate income, insurance premium, fiduciary, franchise, sales & use, replacement, moneys & credits, and withholding taxes depending on the tax credit type.

Only the Iowa Legislature can enact or repeal tax credits, although some credits have established sunset dates upon enactment. The very first tax credit was the Motor Vehicle Fuel Tax Credit which was enacted in 1973. Since then there have been many tax credits that have been enacted, although some of those tax credits have subsequently been repealed. In tax year 2006, there were 26 nonrefundable and refundable tax credits that could be claimed on the IA 148. That increased to 30 tax credits in tax year 2010. An additional four credits could be claimed on the quarterly withholding return.

The Tax Credit Tracking and Analysis Program (TCTAP) was established in 2005. Prior to the establishment of the TCTAP, the Department of Revenue (IDR) did not track the specific tax credits claimed on tax returns. Starting in tax year 2006, IDR required the IA148 Tax Credits Schedule to be filed by all taxpayers claiming "other nonrefundable" and/or "other refundable" tax credits on their returns. This allows IDR to verify tax credit claims and to accurately report claim information. Every tax credit claim reported on the IA148 is examined and corrections are made when errors are identified.

The tax credits represented in this portion of the study include all credits that were eligible to be claimed during the 2010 tax year using the IA 148 Tax Credits Schedule or on the quarterly withholding return. Individual income tax credits that are claimed on a separate line on the IA 1040 are not included.